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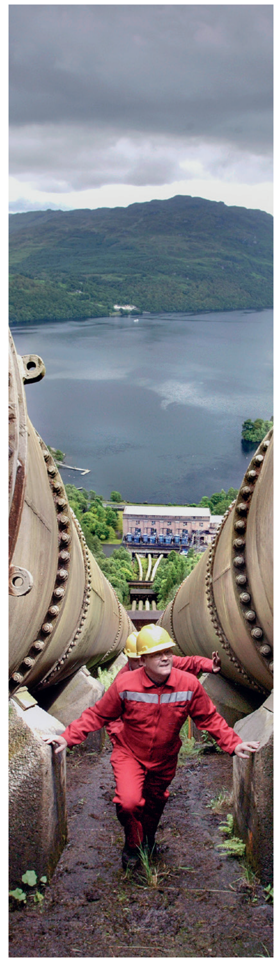
THE MARKET FOR SME FINANCE IN SCOTLAND




HIE
Highlands and Islands Enterprise
Iomairt na Gàidhealtachd 's nan Eilean

Scottish Enterprise

The Scottish Government
Riaghaltas na h-Alba

THE MARKET FOR SME FINANCE IN SCOTLAND

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THE MARKET FOR SME FINANCE IN SCOTLAND

Introduction

Small and Medium-sized enterprises (SMEs) are essential to the Scottish economy, and to delivering our ambition, as set out in *Scotland's Economic Strategy*, to achieve a more productive, cohesive and fairer Scotland.

To grow, become more innovative and productive, create jobs, and seek opportunities in new markets, SMEs often require access to appropriate and affordable finance.

This report considers the market for business finance in Scotland, drawing on an extensive evidence base, and our engagement with key stakeholders from across the financial sector, wider business sector and public sector partners.

It finds that whilst Scotland benefits from extensive business banking services and a vibrant angel investment community – and many SMEs are able to access the funds they require – there is evidence of viable Scottish SMEs across all sectors facing challenges raising the funding they need. There is also evidence that others are discouraged from applying for the finance they need as they do not believe they will be successful.

The evidence suggests that:

- Whilst the size and nature of the annual lending gap can vary over time, based on the latest available evidence it is estimated to be in the range of £330 million to £750 million in Scotland. Loans under £1 million are the hardest to obtain.
- There are ongoing gaps for firms seeking seed and early-stage equity investment, as well as those seeking to raise over £2 million.
- Raising finance is often most challenging for newer companies; those with no or limited security; and faster growing firms.

Research[1] shows supporting access to appropriate finance can help company growth. This may help us overcome long-standing challenges such as Scotland's smaller number of medium-sized enterprises, lower productivity performance, and lower levels of exporting compared to our international competitors.

We, along with our Enterprise Agency and Local Authority partners, are already taking forward a range of actions to address gaps in both the supply of, and demand for finance.

The Scottish Investment Bank is providing equity investment alongside private sector partners to support early-stage innovative companies access risk capital investment. The Enterprise Agencies provide a range of financial advice and support, including direct support for companies looking to raise finance, whilst the local authority loan funds provide loans to small and growing businesses that cannot attract all the funding they seek from private sector funders.

We will build on these actions by: identifying mechanisms to access new sources of capital which can be used to increase the level of funding available to SMEs, making it easier for SMEs to access this funding, and increasing the range of financial advice and support available to SMEs.

The establishment of a Scottish Business Development Bank, which is able to bring new sources of finance to Scotland, will form a key part of this approach. This report sets out some of the lessons that we have learnt on approaches in other European countries.

We will work in partnership with our successful Enterprise Agencies, local authorities, other public bodies, private sector providers, and European Union and UK institutions to take forward this approach, ensuring the best possible environment for our SMEs to grow and thrive.

THE IMPORTANCE OF SMEs TO THE SCOTTISH ECONOMY

SMEs make a vital contribution to the Scottish economy.

As at March 2014[2], there were 332,720 SMEs[3] in Scotland of which those with employees represented 31 per cent or 103,000 firms. Since 2007, the number of registered enterprises in Scotland has increased by 10 per cent, with those SMEs with employees driving this increase[4]. SME employers now account for 42 per cent of all private sector jobs and 34 per cent of private sector turnover.

SMEs have a vital role to play in delivering the ambitions set out in *Scotland's Economic Strategy*[6]. The Strategy focuses on the two mutually supportive goals of increasing competitiveness and tackling inequality. These goals are underpinned by four priorities for sustainable growth: investing in people and infrastructure; fostering a culture of innovation; promoting inclusive growth; and promoting Scotland on the international stage.

Supporting the growth of Scotland's SMEs can also help address some long-standing challenges in the Scottish economy[7 8], such as:

- a gap in the number of medium-sized companies in Scotland, relative to countries such as Germany, Austria, Finland and Sweden;
- narrowing the gap in Scotland's productivity performance relative to key international competitors;
- relatively low levels of international exporting activity;
- diversifying and expanding the business base; and
- supporting reindustrialisation.

Table 1: Number of Private Sector Registered and Unregistered Businesses in Scotland by Sizeband 2014[5]

		Number of enterprises	Number of people employed	Turnover (£ millions)
Small and Medium Enterprises	0 employees	229,625	257,530	11,130
	1-49 employees	99,315	610,500	55,716
	50-249 employees	3,780	256,260	36,494
Large	250+ employees	2,295	928,560	169,203

THE MARKET FOR SME FINANCE

The market for SME finance is constantly changing.

Box 1 provides an overview of the range of market financing options for SMEs.

Our banks successfully continue to meet the vast majority of debt requirements of Scottish businesses through overdrafts, loans and other support such as invoice finance and asset based lending. Eighteen per cent of companies sought bank finance over the last 12 months and 80 per cent of those received the finance they needed[9 10]. Equity is an important finance option and a flexible way of supporting growth. It may be more appropriate for some early stage businesses and has the potential to create significant economic and employment outcomes[11 12]. The Scottish equity finance landscape is now markedly more dynamic, diversified and complex than ever before[13]. However, evidence suggests that only 1 per cent of businesses currently raise equity from third parties despite the advantages[14].

As well as more traditional debt and equity markets, companies, including social enterprises, can now access finance through the emerging alternative funding market, such as Crowd Funding and Peer to Peer Lending. Despite very rapid growth, alternative funding currently represents a small proportion of the overall market. However, it offers a valuable and welcome alternative alongside traditional sources of finance.

Scotland benefits from a supportive environment for SMEs seeking to grow, with a number of public sector finance initiatives tackling certain identified market gaps and delivering significant impact. Local Authority loan funds, the Scottish Investment Bank co-investment funds, the Scottish Loan Fund and specialist sector support funds such as the Renewable Energy Investment Fund have invested significant sums and supported growth.

Annex A provides an overview of evidence relating to the market for SME finance.

Box 1: Overview of the Market for SME Finance

Debt

- The total SME bank loan market in Scotland was £6.7 billion in the first quarter of 2015 with banks also supplying £1.2 billion of overdrafts to Scottish SMEs in that period[15].
- Since the financial crisis in 2008 there have been dramatic changes in finance and business needs. In 2014 a higher proportion of firms were using loans to purchase land or capital equipment than in 2012 and a lower proportion were using overdrafts for working capital or cashflow[16].

Equity

- The latest Scottish Risk Capital Market report highlights increasing demand for equity. Annual investment increased 74 per cent from £116 million in 2012 to £202 million in 2013[17].
- For investments between £100,000 and £2 million, business angels account for around 35 per cent of total funding. Over the past five years, Scottish angels and angel groups within the LINC Scotland trade body have invested between £14 million and £17 million per annum. Tax relief provides incentives across the UK for angel investment activity, with Scottish public sector support enabling activity in excess of other UK regions.
- The Business Growth Fund was established by five banks to increase long-term growth capital[18]. It invests £2 – £10 million in businesses with turnover between £5 million and £100 million.

Alternative sources

- Alternative funding is growing rapidly. The UK market more than doubled in size year on year from £267 million in 2012 to £1.74 billion in 2014[19]. London and the south east dominate with Scotland's take up of alternative finance similar to other UK regions.
- Online crowd funding platforms provided around £84 million of equity funding in 2014[20]. A 2013 consultation by the European Commission[21] suggested that the average amount secured by companies from an equity crowd funding platform was €50,000.
- Peer to Peer Lending is generating increased market activity with £749 million provided in 2014[22]. There are presently in excess of 25 UK-based lending platforms and the number is rapidly increasing.
- The use of asset based finance is also growing; the quarter to June 2014 saw £18.9 billion provided to all businesses, 80 per cent of which was invoice discounting[23]. Much of this is provided by banks.

Social Enterprise Investment

- Scotland has 3,500 social enterprises, employing 76,000 people and with £3.8 billion turnover[24]. Seventy-three per cent of those surveyed said that financial support is necessary for future development, with 51 per cent indicating a need for business development support.
- Innovative developments continue across Scotland and the UK including Social Impact Bonds, Big Society Capital (backed by the major banks) and the Scottish Community Re-investment Trust.
- Related sources of specialist finance and investment include credit unions and Community Development Finance Institutions (notably Social Investment Scotland, which is now one of the largest in the UK).

GOOD SCOTTISH FINANCE NEWS:

18% OF SMES SOUGHT FINANCE IN 2014

80% OBTAINED THE FINANCE THEY REQUIRED

£202m EQUITY INVESTMENT INTO SMES IN 2013

£8bn BANK LOANS AND OVERDRAFTS TO SCOTTISH SMES IN Q4 2014

MIND THE FINANCE GAP:

UP TO £0.75BN ESTIMATED ANNUAL LENDING GAP TO VIABLE SMEs IN SCOTLAND

13% OF SMES WHO DID NOT APPLY FOR FINANCE HAD NEEDED SOME

UP TO £1M MOST CHALLENGING FUNDING FOR BUSINESSES TO RAISE

OVER 50 COMPANIES ESTIMATED TO NEED OVER £2M OF EQUITY OVER NEXT 3 YEARS

GERMANY, AUSTRIA, FINLAND AND SWEDEN BUILD MORE MEDIUM-SIZED COMPANIES THAN SCOTLAND

ALMOST 40,000 NEW BUSINESS BIRTHS IN SCOTLAND IN LAST 2 YEARS

103,000 SMEs IN SCOTLAND WITH EMPLOYEES

CREDIT CONDITIONS TIGHTEST FOR SMALLEST COMPANIES

BENEFITS OF PAST SCOTTISH GOVERNMENT AND PARTNER INVESTMENT:

3,125 ESTIMATE OF JOBS CREATED OR SUPPORTED BY LOCAL AUTHORITY LOANS SINCE 2009-2014

£520m PRIVATE INVESTMENT LEVERAGED FROM SIB CO-INVESTMENT ACTIVITY TO MARCH 2015

GAPS IN THE MARKET FOR SME FINANCE

The range of financing options provided by the market means that many SMEs are able to access the finance that they require. However, evidence suggests that there are gaps in the market for both SME debt and equity finance, which results in some SMEs being unable to secure the finance they need.

Being unable to access appropriate finance can limit SME cash flows and hamper business growth prospects[25].

As the market for SME finance is constantly evolving the precise scale and nature of these gaps changes over time.

At any particular point in time, the funding gaps reflect two broad factors. Firstly there are long-standing structural gaps some of which can affect certain types of firms. For example, start-ups, early stage high-growth companies and technology-intensive firms have generally found it more difficult to secure finance. Secondly, cyclical gaps in lending affect a range of SMEs and reflect changes in economic conditions and regulatory requirements.

Box 2 provides a summary of the current evidence on the funding gaps for investable SMEs, drawing on a range of evidence from various reports and commentators:

- Whilst the size and nature of the annual lending gap can vary over time, based on the latest available evidence it is estimated to be in the range of £330 million to £750 million in Scotland. Loans under £1 million are the hardest to obtain; and
- In the equity market there are ongoing gaps, especially for those firms seeking investment in the start-up and early investment stages, as well as increasingly in raising over £2 million investment.

The Scottish SME banking sector is concentrated, with the Royal Bank of Scotland, Lloyds Banking Group and Clydesdale Bank accounting for over 80 per cent of the sector[31]. The July 2014 Competition and Market Authority (CMA) report into SME banking[32] also found high levels of concentration with 90 per cent of Scottish business loans provided by the same three banks. Scotland may benefit from more diversity in funding options.

Whilst all banks continue to lend, they also continue to restructure their balance sheets, which has produced change in availability and lending terms. Bank debt may not be appropriate for some companies, such as emerging businesses with innovative products or business models[33]. Viable firms might be unable to secure funds where it is challenging for lenders to distinguish between high-risk and low-risk companies given the availability of information or diligence or the cost effectiveness of obtaining it[34]. Banks seek to lend responsibly and against affordability criteria, which means a business that lacks the necessary cash flow to service the debt will likely need to consider alternatives.

Evidence, which is supported by discussions with the lending sector and business representative bodies, suggests that SMEs may find it difficult to access traditional lending where they[35]:

- have security shortfalls;
- are relatively new and are unable to demonstrate a track record in performance; and
- are growing fast at home or abroad.

Finance gaps can arise for established and new companies for a number of reasons:

- debt is repaid from cashflow and lenders wish to lend responsibly. Banks request financial projections to asses potential future trading and cashflows, and when these are not available lenders will use a company's prior years' history as a proxy for future. New companies (less than two years old) may not be able to evidence sufficient track record, and fast growing companies may not evidence confidence in increased future cashflows;
- lenders require that their loan is repaid with interest, and need to seek to recover their money if the company defaults. Loans are typically secured on land or property, and through regulatory parameters, limited to a maximum percentage of the total asset value. Therefore a fall in property values could reduce the amount 'loan to value' lenders are able to lend. For example, the fall in UK property values during the recession – UK Commercial property values are estimated to have fallen £184 billion since 2007[36] – is likely to have contributed to a tightening in lending conditions. Some companies with few assets struggle, such as those that lease their property;
- any change in key management or a restructure where cash benefits are not expected for some time may present an increased risk; and
- banks borrow some funds on wholesale markets, which may have required repayment within a timeframe that makes longer-term loans more challenging.

The market for early stage equity finance is characterised by long standing structural features that limit the availability of equity finance for early stage, higher risk growth companies. Cyclical patterns exacerbate these market failures with recessions generally leading to a tougher environment for raising funds and lengthened investment cycles reducing the re-cycling of funds into new ventures.

These structural challenges require on-going support to ensure that Scotland's best company prospects can access the funding they need for growth. While Scottish Investment Bank funds have been effective in funding successes at the early stages, market challenges remain, particularly as the trend over the last decade has been for investors to minimise risk by seeking to support companies at a later stage in their development[37].

We, along with our Enterprise Agency and Local Authority partners, have a range of successful interventions which are targeted at aspects of the gap. **Box 3** provides a summary of these.

Annex A provides a range of illustrative case studies of companies who have successfully secured finance through public sector initiatives.

Box 2: Overview of the Evidence Base on Funding Gap for SME Finance

Estimates of the Gap in the Debt Market

- Analysis by BIS in March 2012 suggested that the UK-wide SME debt gap could be in the range of £26 billion to £59 billion over five years[26].
- The *Ex-ante assessment of EU SME Initiative*[27], a European Commission report, estimates the upper boundary of the annual UK-wide debt gap to be €9.1 billion (£7.4 billion) which would proportionately be €0.58 billion/ £0.47 billion annually in Scotland.
- Given this evidence, and based on Scotland's share of UK SMEs, the debt gap in Scotland is estimated to be in the range of between £330 million to £750 million per year, although the size and nature of the gap can vary over time.
- Feedback from ICAS members suggests that it is most difficult to obtain funding of between £100,000 and £1 million across a range of businesses with differing growth opportunities and historical track records[28].

Estimates of the Gap in the Equity Market

- The British Business Bank[29] confirms the continued existence of an equity gap across early stage funding, and also shows this to be widening and extending to larger (£2 million +) investments.
- The trend over the last decade has been for investors to minimise risk by seeking to support companies at a later stage in their development compounding challenges for companies in raising equity[30].
- There are gaps for larger amounts of support, too large for business angels and too small for traditional private equity funds. Some businesses that previously secured early stage funding up to £2 million are finding it challenging to access further growth funding where investors do not have follow-on capital or where the transition from angel investment to venture capital funding does not work effectively.
- Discussions with stakeholders suggest there are a number of companies with a potential funding requirement of £2 million or more over the next three years.

Box 3: Current Scottish Public Sector Support

Scotland benefits from a supportive environment for SMEs seeking to grow, with various public sector finance initiatives tackling certain identified market gaps and delivering impact.

Local Authority loan funds

- Provides loans up to £100,000 and, typically around £25,000-£40,000, to small and growing businesses that cannot attract all the funding they seek from private sector funders.
- Over £9 million of European Regional Development Funds has been invested by the Scottish Government in the three main schemes since 2009, with West of Scotland and East of Scotland consortia adding further investment.

The Scottish Investment Bank (SIB) Co-Investment Funds

- As a division of Scottish Enterprise, SIB manages a number of early stage equity co-investment funds, supported by the European Regional Development Fund, investing in partnership with private sector investors.
- SIB's model has been catalytic in building and growing the early stage investment market in Scotland and is highly respected and replicated across the world as an effective means of sharing risks and rewards with private sector investors, providing critical growth capital to some of Scotland's most dynamic and high growth prospects.
- From 2003 to March 2015, investments of over £215 million in the range £20,000 – £2 million have levered over £520 million of private sector capital, nearly half from international investors, supporting around 450 companies.
- Evaluations[38] of the co-investment funds have identified high levels of investment additionality and estimate the forecast net GVA impact of the companies supported through the funds in the range of £739 million to £1.231 billion over 10 years. These companies are adding value to the economy in terms of value creation, high value jobs and investment in R&D and the Funds also deliver income to the public purse.
- As at March 2015, the portfolio of companies supported over 3,500 skilled jobs in the economy and turnover of over £340 million. The Scottish Co-Investment Fund, which invests predominantly with business angels, has supported the rapid increase in local angel investor groups from around two in 2003 to over 20.

The Scottish Loan Fund

- Launched in 2011 as part of the Economic Recovery Plan to focus on an identified gap in the support of funding to SMEs, the Scottish Loan Fund (SLF) is a niche product for established high growth and exporting companies who need mezzanine debt to support their growth plans.
- Scottish Enterprise's commitment of £55 million, including £20 million European Regional Development Funds allocated from the Scottish Government, levered nearly £60 million from private sector investors.
- To August 2015, 28 companies have already accessed this investment. An independent economic impact assessment of the Fund, (based on 15 businesses only securing funding) estimated potential to generate a cumulative net additional GVA over 10 years of £88 million for these companies.

Box 3: Current Scottish Public Sector Support (contd.)

Specialist Sector Support Funds

- Scotland has a track record of responsive and innovative financial instruments to support economic development, infrastructure investment and innovation, in partnership with the private sector. Examples include the Scottish Government-established Renewable Energy Investment Fund (REIF), delivered by the Scottish Investment Bank, and the Scottish Investment Bank's investment into Epidarex Capital's Life Sciences Fund.

Financial Innovations

- Initiatives led or facilitated by the Scottish Government and the Scottish Futures Trust such as in Non Profit Distributing Finance, Hub, Tax Incremental Financing, the Growth Accelerator Model and the National Housing Trust, typically bring together private and public sector investment and interests into projects which unlock financial, public and social value.

There is also an important role in stimulating demand for funding (**Box 4**). This will ensure a continuing improvement in accessing finance for those viable SMEs that can make a key contribution to driving long-term economic competitiveness.

Box 4: SME Demand for Finance

To deliver Scotland's growth ambitions it will be important to boost the demand for finance amongst Scotland's SMEs with the potential for investment. For example:

- The British Business Bank found that just over half (54 per cent) of all SMEs in the UK had used external finance in the last three years, a lower proportion than in 2012[39]. Similarly, the BDRC-Continental SME Finance Monitor found that only four in ten SMEs in Scotland were using any external finance in 2013[40].
- The Small Business Survey reports that just under a third (31 per cent) of Scottish SMEs applied for finance over the last three years. This is lower than the 45 per cent of SMEs that had sought finance in the Scottish Government's 2012 Access to Finance Survey[41].
- There is some evidence that even firms that plan on growing are reluctant to use external finance, with 60 per cent of SMEs stating that it was unlikely they would approach external finance providers.
- There is also a cohort of SMEs which need finance but do not apply due to perceptions that they would be unsuccessful in obtaining finance.
- Recent British Banking Association statistics show that demand for debt is lower when deposit levels are higher, given the ability to self-fund[42].

MORE THAN JUST FINANCE

To maximise the impact of financial interventions it is important that they are coupled with advisory led support, to provide value-adding education and understanding of financial options, and wider support to reduce company risk and boost growth.

Evidence from the Small Business Survey[43] shows that 86 per cent of those businesses which sought financial advice found the advice to be of some or significant benefit. The survey also shows that currently only a small proportion of businesses have sought financial advice.

In the face of greater competition for international equity investment, the need to further raise the standards and quality of the offer to investors becomes paramount. Some companies require significant support and advice in preparing their propositions. An important consideration relates to understanding the characteristics, from an international investor's perspective, of an attractive proposition and helping ambitious Scottish companies showcase these.

We, along with our Enterprise Agency and Local Authority partners, are providing a range of financial advice and support through initiatives such as the Scottish Investment Bank's Financial Readiness service, incubators and accelerated growth programmes. This can:

- help support companies in understanding the funding landscape and appropriate funding options for their business; and
- provide facilitation of strategic planning workshops to help businesses present funding propositions and to be 'financially ready' to raise finance.

Financial advice and support can also be provided through national assets including our diverse network of Global Scots managed by Scottish Enterprise. This can increase the benefit and impact of finance through advice, contacts and practical assistance.

These services also link into the wider range of business support services. Our Enterprise Agencies and Business Gateway are a key element of the wider provision of SME growth advice and support. Companies move through different phases within their life cycle, benefiting from tailored support and often from more than one organisation.

Examples of the wider range of support available includes:

- Advice on improving efficiency or processes from the Scottish Manufacturing Advisory Service
- Access to Company Director Development Programmes from the Institute of Directors
- Business specific workshops on developing international marketing strategies
- High-level reviews of business-specific intellectual property issues and IT health-checks
- Access for account-managed clients to in-depth knowledge of specific international markets or territories from Scottish Development International's overseas staff.

Our approach to business finance will ensure that financial advice and support is available to a broader range of SMEs, whilst strengthening the links across the wider range of business support.

APPROACHES IN OTHER EUROPEAN COUNTRIES

In many European countries, Business Development Banks or Funds form an important aspect of their overall approach to addressing gaps in the market for SME finance.

Analysis by the University of Strathclyde[44] considered different delivery models for these Banks/Funds across a number of European countries. The research found that:

- Investment funds, public financial institutions and public banks are common tools of public policy. All countries examined use one or more at national or regional levels. They offer direct SME support, indirect fund-of-funds, partnership collaborations, infrastructure investment, local authority lending, and international operations. **Box 5** provides an overview of approaches in Denmark, Ireland, and Germany.
- All are exclusively, or almost entirely, publicly owned. They are steered by means such as specific legislation, government goals, and ownership. Some co-invest in each other, some access European Investment Bank finance.
- While all were first endowed with capital by the state, many now raise funds in domestic and international markets. Some institutions have access to state guarantees which can underwrite a proportion of their loans or debt securities.
- The different models can include a range of objectives including supporting business start-ups, growth, exporting, regional policy, innovation, long-term investment, restructuring and modernisation. All of the models considered in the report offered loans and some provide guarantees, equity or access to grants.
- Some models encourage support for social objectives. Others have sector-specific products such as for renewable energy, housing, and infrastructure.
- The European Commission encourages Member States to use EU funds for financial instrument interventions; in the 2007-2013 period, over 900 financial instruments were co-financed at national or regional levels. Development Banks typically manage their nations' European Regional Development Fund (ERDF) programmes.

Box 5: Examples of Business Development Banks and Funds Across Europe

The European Policy Research Centre at the University of Strathclyde found substantial differences in the nature of the structural models pursued, and also that they could be grouped under three broad headings: Investment Funds; Public Financial Institutions; and Public Banks.

Investment funds

Investment funds generally have a remit limited to supporting SME development, although some funds can be targeted at specific elements of business investment such as supporting innovation (for example the Netherlands Innovation SME+ scheme).

The Danish Growth Fund (*Vaekstfonden*) is an example of an investment fund. Its mission is to “contribute to the growth of economically viable yet uncertain small and medium-sized companies.”

The Fund is a major provider of business finance in Denmark. It provides loans and guarantees to, and invests equity in, both small and medium-sized companies. This funding is provided in collaboration with private partners and Danish financial institutions.

The Fund undertakes both direct and indirect venture activities. Direct investment means that the Fund holds stakes in a number of companies and takes responsibility for active co-ownerships. Indirect investment tends to be through allocating funds to private sector venture capital providers.

Ultimate responsibility for the Fund rests with Denmark’s Ministry for Economic and Business Affairs, although it is governed by an independent board of directors.

Public financial institutions

They usually operate more than one fund and often collaborate with other organisations. Their focus is generally on SME development.

The Strategic Banking Corporation of Ireland (SBCI), which was launched in October 2014, is an example of this model. The SBCI is a state-owned institution, which has been established as a limited private company based in the National Treasury Management Agency.

The SBCI does not provide direct support to SMEs. It offers SMEs long-term working capital and capital investment finance through lending partners, initially AIB and Bank of Ireland.

The SBCI has also sourced funding from the KfW (the German development bank), the European Investment Bank, and the Ireland Strategic Investment Fund (which invests the assets of the National Pensions Reserve Fund on a commercial basis).

Public Banks

The operations of public banks, such as the KfW Banking Group in Germany, tend to be on a more substantial scale relative to the other models, and their functions can often extend beyond just supporting SME development.

Whilst the KfW is an independent entity operating on a commercial basis, its goals are set in federal law and target the provision of public goods. The Bank’s loans and debt securities are guaranteed by the Federal Republic[45].

It was initially established with public funds, but now raises over 90 per cent of its capital on commercial markets. The KfW has been assigned a triple-A credit rating by all three financial ratings agencies[46].

It is a substantial organisation with over 5,300 employees in 2013 and a balance sheet of nearly 465 billion euros.

The objectives of the KfW are wide and cover not just support to SMEs, but also to individuals (such as student and apprenticeship loans) and to local authorities (in particular long-term loans for capital investment).

In the majority of cases KfW loans are distributed through savings, cooperative banks and commercial banks.

APPROACH

This report highlights the continued gaps in the markets for SME debt and equity, although the precise scale and nature of these gaps changes over time. There are also ongoing challenges around demand for finance with some companies discouraged from applying.

To address these challenges and increase access to finance and support, we will build on what works, extend our reach and access new capital sources and expertise.

Our approach will focus on increasing the level of funding available to SMEs, expanding and deepening financial support and advice, and providing easier access for SMEs seeking finance in order to:

- support company growth, particularly to build more medium-sized and larger enterprises;
- contribute to the development of the economy by supporting and creating jobs; increasing economic growth; increasing exporting, innovation, and investment; and engendering fairness and equality; and
- support the business finance market to work more effectively.

We will continue to support public sector funders, such as the Scottish Investment Bank and the work done by local authority loan funds. We also wish to broaden diversity of supply of finance. Once fully established, a Scottish Business Development Bank should:

a) act as a mechanism to bring new investment into Scotland to help fill key funding gaps

b) deploy or manage Scottish resources

c) manage financial risk including across financial years

d) be sustainable and evergreen, including building reserves

e) satisfy any relevant regulatory requirements and build the necessary financial credentials to support effective operation

f) enable and provide financial instruments through existing and new funding partners.

There are challenges in developing the Bank. For example, in relation to the interaction of our ambition with UK public finance rules, such as the ability to raise and spend investment, manage funds across more than one financial year, build reserves and reinvest surpluses. Learning from others across Europe, we will develop the best mechanism or entity to raise such investment.

We will set out in late 2015 options for the Bank, how it will operate, and a timetable for introduction.

ANNEX A

CURRENT EVIDENCE ON ACCESS TO FINANCE

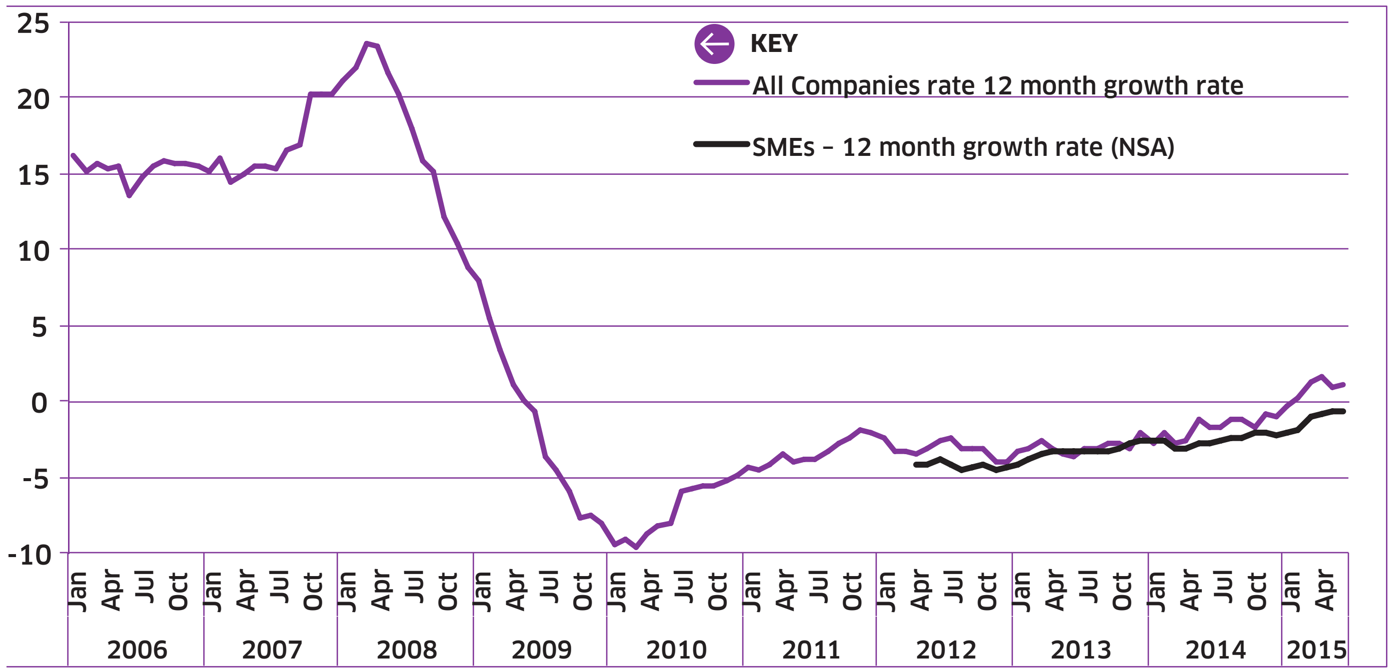
Debt

Banks continue to meet the vast majority of Scottish business needs for debt, through overdrafts, loans and other support such as invoice finance and asset based lending. The total SME bank loan market in Scotland was £6.7 billion in the first quarter of 2015 with banks also supplying £1.2 billion of overdrafts to Scottish SMEs in that period. Banks review a company's future forecasts, past performance and ability to repay, taking security and pricing facilities based on risk and security levels. They manage their loan book to ensure a low level of default. Higher defaults affect the amount of capital they need to set aside. The SME sector is a higher relative risk to banks than larger businesses, not least because of average SME life expectancy.

Since the 2008 financial crisis, there has been a significant fall in lending to SMEs. This has been driven by both a decline in lending from its pre-recession peak and a decrease in demand.

Evidence from the Bank of England shows the seasonally adjusted 12-month growth rate of lending (loans and overdrafts) by financial institutions to non-financial companies in the UK remained negative until the beginning of 2015. (Figure 1). However, the growth rate is still significantly below the pre-recession rate which averaged over 15 per cent[47] and peaked at 24 per cent in March 2008. In addition, the 12-month growth rate of lending to non-financial small and medium sized businesses (loans and overdrafts) has been negative since the series began in 2012, although it has continuously become less negative over the period.

Figure 1: 12-month growth rate in lending
Source: Bank of England, BankStats

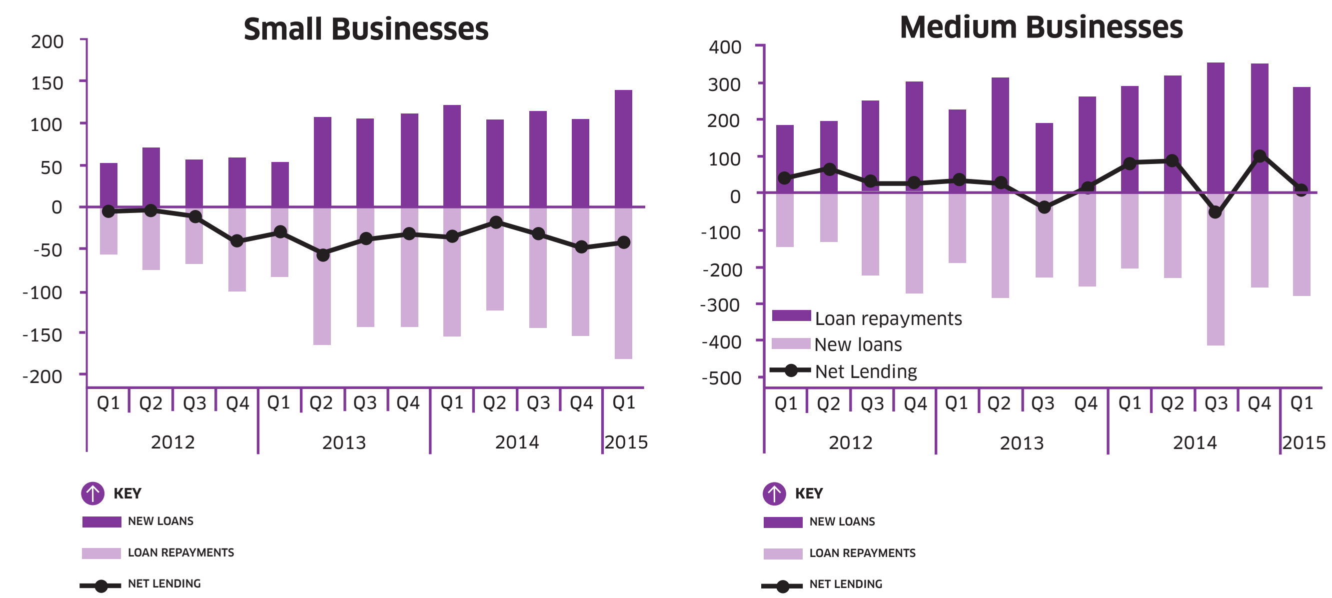


The British Bankers Association[48] statistics show that while net lending to medium firms has been largely positive in Scotland since late 2011 to the most recent quarter, it has been negative for small businesses[49] (Figure 2). The data also shows that negative net lending statistics can be explained by firms making loan repayments in excess of new borrowing.

New banks are emerging. Some, such as TSB or Williams and Glyn, are spin offs from larger banks, others are new players such as Aldermore. There are also growing players such as Santander. The impact of changes in the landscape has not yet been fully seen in Scotland. Regulators are also taking steps to increase competition by streamlining the application process for new banking licences.

The Scottish Government's latest assessment of access to finance conditions for those SMEs with employees[50] suggests demand for finance remains subdued, with a fall in the number of SMEs looking to access finance and the persistence of discouraged and reluctant borrowers.

Figure 2: Lending to Scottish SMEs
Source: Bank of England, BankStats



Many SMEs do not use any form of external finance. Evidence from the British Business Bank found that just over half (54 per cent) of all SMEs in the UK had used external finance in the last three years, a lower proportion than in 2012[51]. Similarly, the BDRC-Continental SME Finance Monitor found that only four in ten SMEs in Scotland were using any external finance in 2013[52].

The Small Business Survey reports that just under a third (31 per cent) of Scottish SMEs applied for finance over the last three years. This is lower than 45 per cent of SMEs that had sought finance in the Scottish Government's 2012 Access to Finance Survey[53]. Over the last 12 months, the demand for external finance has continued to be relatively low with only 18 per cent of Scottish SMEs applying for finance during 2014. This is a lower proportion than in 2012, a trend which is mirrored in the findings of the (UK wide) SME Finance Monitor and the UK results from the Small Business Survey.

There is also some evidence that even firms that plan on growing in the future are reluctant to use finance, with 60 per cent of SMEs stating that it was unlikely they would approach external finance providers to fund growth. Similarly, the latest SME Finance Monitor[54] also finds that only half of UK SMEs are happy to use external finance to help them grow, with a fifth of SME employers described as "debt averse". However, the SME Finance Monitor concluded that although a large number of SMEs have a preference for paying down debt, SMEs are still prepared to use external finance in the right circumstances.

Alongside those businesses who do not wish to take on debt, there is also a cohort of SMEs which need finance but do not apply due to perceptions that they would be unsuccessful in obtaining finance. The 2014 Small Business Survey found that of those SMEs that did not apply for any finance, 13 per cent had a need for finance in the previous 12 months. In addition, of those SMEs that did apply for finance, 12 per cent had need for additional finance which they did not apply for.

Of those firms that sought finance, it was mainly bank loans or overdrafts that were applied for. However, fewer firms reported applying for overdrafts than in the previous survey and more sought leasing or hire purchase arrangements. There is some evidence showing that less funding is being sought for day-to-day cashflow with more being invested in acquiring capital equipment or buildings. Together these suggest that SMEs may be beginning to use external finance to invest and grow which is also suggested in the official business investment statistics.

The concentration of the SME banking sector in Scotland, where three banks dominate the sector, is also likely to have an impact on SME use of debt finance. Royal Bank of Scotland, Lloyds Banking Group and Clydesdale Bank account for over 80 per cent of the SME banking sector[55]. The July 2014 Competition and Market Authority (CMA) report into SME banking[56] also found similar levels of concentration but also that 90 per cent of business loans in Scotland are provided by the same three banks. Both the CMA and British Business Bank[57] find that SMEs generally seek finance from their main bank account provider and often this is the only provider approached with no alternatives considered.

Whilst demand remains subdued, supply of finance has improved for SMEs with Scottish SMEs faring better than those in the UK as a whole. More SMEs are managing to obtain all the finance they need from the first source approached and fewer are obtaining none of the finance they applied for. Evidence from the SME Finance Monitor supports this and shows that outcomes for Scottish SMEs are generally more favourable than for those in other parts of the UK. Similarly, the number of independent appeals that overturn banks' decisions to reject lending has decreased in recent quarters, suggesting that banks are communicating more effectively with businesses and businesses are approaching banks better prepared with the necessary information.

Equity

The Scottish equity finance landscape is now markedly more dynamic, diversified and complex than ever before[58]. Only 1 per cent of businesses currently raise equity from third parties[59] but these tend to be innovative, export-led enterprises which make a disproportionate contribution to job creation and economic growth. Equity is generally more appropriate for high growth businesses.

Scotland's business angel investment activity is well established and organised and has played a key role in improving the availability of seed and early stage investment up to £2 million. Tax relief (Enterprise Investment Scheme and Seed Enterprise Investment Scheme[60]) is a major part of the angel space, providing a strong incentive for what is a risky activity, and Scottish public sector support has enabled activity in excess of other UK regions. For investments between £100,000 and £2 million, the most recent analysis shows that business angels account for around 35 per cent of total investment. Over the past five years, angels and angel groups within the LINC Scotland trade body have invested between £14 million and £17 million per year[61].

There is a need for increased amounts of follow-on investment before company exits are achieved, the time of which have lengthened considerably over recent years from an average of 7 to 10 years. This lack of re-cycling of returns limits the amount of investment available for new ventures.

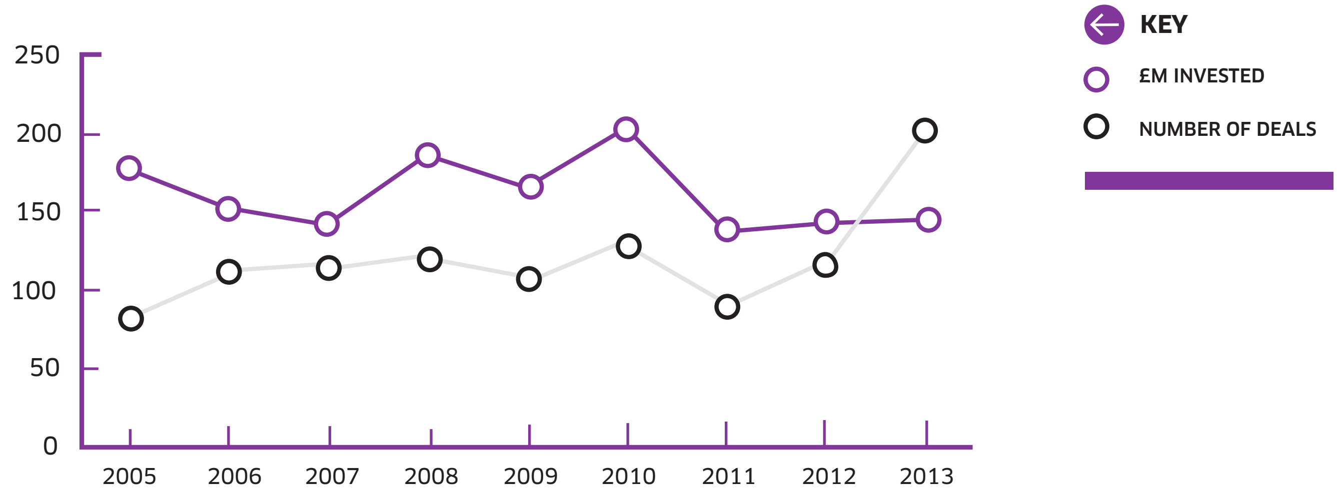
Evidence from research undertaken in Ireland[62] shows that the performance of VC backed companies has been significantly better than the economy generally. Venture backed companies increased employment by 19.3 per cent in 2012 and by 10.5 per cent per annum since 2009. This compares to an overall increase in employment in the economy of 0.06 per cent in 2012 and to a decrease of 1.2 per annum since 2009.

The recession had a fundamental impact on the shape, structure and operation of the Venture industry and following a period of consolidation, there is limited evidence of growth in the supply of VC capital. Globally, there is a trend toward fewer, larger value deals, as investors seek less risky propositions. Companies face challenges when looking to secure investment of more than £2 million, the so called "second" equity gap.

The Business Growth Fund was established by five of the major banks to help address some of the perceived equity gap related to long-term growth capital. It takes a minority stake of £2 million to £10 million in growth businesses with turnover between £5 million and £100 million.

The latest report on the Scottish Risk Capital Market demonstrates an increase in demand for equity investment, with total annual investment increasing by 74 per cent from £116 million in 2012 to £202 million in 2013[63]. Although deal numbers have stayed relatively constant, the total amounts invested have increased substantially due to significant capital investments in a small number of deals. This trend continued into 2014.

Figure 3: Investment trends 2005-2013



Source: Scottish Risk Capital Market in Scotland Report 2012-2013, Young Company Finance.

Other Sources of Finance

The alternative funding market is growing rapidly, with the UK market more than doubling in size year-on-year from £267 million in 2012 to £1.74 billion in 2014[64]. London and the south east dominate these figures with Scotland's take up of alternative finance similar to the other UK regions.

Online crowd funding platforms provided around £84 million of equity crowd funding in 2014[65]. Established investors and organisations, including the EU and the UK FCA, have expressed concern about the risks involved for individual investors using on line platforms that are conduits for companies to raise equity[66]. The impacts on a crowd-funded business's ability to raise follow on funding have largely still to emerge which is of particular importance to growing businesses that are likely to require significant capital, over a number of investment rounds. A 2013 consultation by the European Commission[67] suggested that the average amount of equity investment secured by companies from an equity crowd funding platform was €50,000.

Peer to Peer Lending is generating growing market activity with £749 million provided in 2014[68]. Direct UK Government support[69] has been provided with £30 million allocated to platforms such as Funding Circle and Zopa. We estimate there are presently around 25 UK-based lending platforms, but this is changing constantly.

The use of asset based finance by all businesses is also increasing, to £18.9 billion in 2013, 80 per cent of which was invoice discounting[70]. Much of this is provided by banks.

Despite very rapid growth, alternative funding still represents a small proportion of the overall funding market in the UK. However, they are continuing to grow and present a valuable and welcome alternative to more traditional sources of finance.

As with all new sources of finance there is a continued need to raise awareness and understanding among businesses' of the pros and cons and appropriate uses of alternative funding. There is considerable diversity in the different platform business models which have emerged and are operating to date which makes the landscape particularly challenging for companies to understand.

CASE STUDIES

The following companies illustrate successful public sector enabled support.

TOUCH BIONICS

Formed in 2003 after being spun out of research conducted as part of the NHS, Touch Bionics is responsible for launching the world's first powered prosthetic hand, i-limb. In 2008, Touch Bionics acquired US firm Livingskin, which manufactures lifelike prosthetic coverings for the i-limb hand and in 2013, they launched the world's most advanced bionic hand, the i-limb ultra revolution. In 2014, the Livingston-based company notched up sales of £13.5 million, up 10 per cent on the previous year, with over 95 per cent derived from exports. The Scottish Investment Bank has provided significant investment into the Company since 2004 through the Scottish Co-Investment Fund and Scottish Venture Fund alongside investment partner, Archangel Investors Limited. These investments have allowed the company to test the feasibility of its technology, access new international markets and establish overseas contacts. Account management support from Scottish Enterprise has helped the company to improve productivity and access new market overseas

CALNEX SOLUTIONS

Linlithgow-based Calnex Solutions has grown to become a leading global player in telecom synchronisation technologies. The company manufactures and supplies a suite of hardware platforms and software to allow network providers to test mobile-phone base-station technology to conform to international standards. The Scottish Investment Bank has supported the Company through several rounds of funding since 2007 alongside investment partner, Discovery Investment Fund. In addition, a £2 million facility from the Scottish Loan Fund (set up by the Scottish Government) in 2013 helped Calnex finance a 20 month project to accelerate development of the next generation platform for emerging, very high speed, 100Gbit/s interface. Scottish Enterprise advice and support has included access to overseas markets as well as support for initiatives to expand and develop organisational capacity.

NETTHINGS

Edinburgh based NetThings has developed a low-cost and flexible Internet-of-Things (IoT) platform, designed to simplify connecting and controlling things over the Internet. Versatile hardware is supported by the NetThings IBM Cloud, delivering world-class data analytics and services. Initially targeted at the energy and building automation market, this technology is suitable for other sectors, including connected car, home medical, assisted living and security. The Scottish Investment Bank first invested into the Company in 2010 through the Scottish Co-Investment Fund alongside our investment partner, Archangel Informal Investments. A further £2 million follow-on funding commitment in May 2014 from Archangel and the Scottish Investment Bank has helped to accelerate the development of the NetThings platform (hardware, software and cloud) and to gain commercial traction in the district heating and new house build markets.

POINT AND SANDWICK DEVELOPMENT TRUST

The Renewable Energy Investment Fund, delivered by the Scottish Investment Bank, supported the Trust by providing a £2.25 million term facility as part of a total funding package of £14.6 million to Britain's largest 100 per cent community owned wind farm at Beinn Ghrideag outside Stornoway on the Isle of Lewis. Funders included Santander Bank, Social Investment Scotland and The Big Lottery. The 9MW wind farm will generate enough energy for over 6,000 homes and will return 100 per cent profit to the community development fund. Over the project's 25 years, this is estimated to reach nearly £50 million net.

DENCHI POWER LTD

This Thurso-based start-up is involved in innovative battery development and manufacture. The founders acquired the business from a US-based multinational who wanted to divest the business with the risk of closure if a buyer could not be found quickly. They sought debt finance for working capital, although those banks approached found a high-tech start-up too risky. HIE arranged a finance package including a significant loan. Anticipated impacts include 33 jobs retained and a growth in turnover of £5.4 million in three years.

RAASAY

ROC is an outdoor adventure and development centre. It leases Raasay House from the Raasay House Community Company. An ambitious programme of works in 2007/08 remedied decades of under-investment to the listed mansion but, just prior to completion, the building was gutted by fire. ROC's capital position, coupled with the need to re-build and equip the house following the fire, and consolidate debts, made the business less attractive to a commercial lender. HIE offered funding support including grant and two loans, thus enabling this business to continue operating in a remote community employing 35 full time equivalent staff during the summer season, which is a significant proportion of the island community.

CRAIGELLACHIE LTD

The company founder used his own funds to purchase Craigellachie Hotel, south of Elgin. He additionally committed significant investment to refurbish and develop the facility, and secured a bank loan. HIE subordinated loan support of around £400,000 bridges the gap on investment of nearly £4 million. The loan has enabled a significant property to be refurbished, offering luxury 5-Star accommodation in an area currently lacking such a facility. The business will employ 35 people and makes an addition to the Moray and Speyside tourism infrastructure

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